

Masthead Logo

McGeorge Law Review

Volume 17 | Issue 1

Article 14

1-1-1985

The Business of Insurance: Exemption, Exemption, Who Has the Antitrust Exemption.

Eric Peter Gillett

Follow this and additional works at: <https://scholarlycommons.pacific.edu/mlr>

Part of the [Law Commons](#)

Recommended Citation

Eric P. Gillett, *The Business of Insurance: Exemption, Exemption, Who Has the Antitrust Exemption.*, 17 PAC. L. J. 261 (1985).
Available at: <https://scholarlycommons.pacific.edu/mlr/vol17/iss1/14>

This Comments is brought to you for free and open access by the Journals and Law Reviews at Scholarly Commons. It has been accepted for inclusion in McGeorge Law Review by an authorized editor of Scholarly Commons. For more information, please contact mgibney@pacific.edu.

The Business of Insurance: Exemption, Exemption, Who Has The Antitrust Exemption.

In 1890, Congress adopted the Sherman Act.¹ The statute was designed to preclude the formation of monopolies and prevent the abuse of economic power.² Not until fifty years later, however, did the insurance industry become subject to this antitrust act.³ In 1944, the United States Supreme Court decided that insurance contracts affected interstate commerce and were subject to federal law including antitrust laws.

In 1945, however, Congress enacted the McCarran-Ferguson Act⁴ in response to concerns expressed by the insurance industry and several states that the states would be precluded from regulating the insurance industry.⁵ The Act expressly reserved to the states the power to regulate the insurance industry.⁶ The Act also granted the industry a limited exemption from federal antitrust laws.⁷ Activity that could be characterized as constituting the business of insurance was granted this limited exemption.⁸

Struggling with the question of whether a given activity constituted the business of insurance, lower courts initially construed the phrase broadly.⁹ Recently, however, the Supreme Court narrowed the interpretation of the phrase.¹⁰ The Court established a three-pronged test to be applied whenever a party raises the McCarran-Ferguson Act as a defense to an alleged antitrust violation.¹¹

The issue of whether an activity constitutes the business of insurance has returned to the fora of the lower courts. The problem of judicial

1. 15 U.S.C. §§1-7.

2. See A. Thompson, *Antitrust And The Health Care Provider* 3 (1979).

3. See *infra* notes 31-35 and accompanying text.

4. 15 U.S.C. §§1011-1015.

5. See *infra* notes 40-43 and accompanying text.

6. See *infra* notes 41-43 and accompanying text.

7. See *infra* notes 40-43 and accompanying text.

8. *Id.*

9. See *infra* note 152 and accompanying text.

10. See *infra* notes 69-113 and accompanying text.

11. See *infra* notes 104-13 and accompanying text.

interpretation, however, remains. Currently, courts are struggling with an uncertain Supreme Court test, as illustrated by inconsistent application of the test in federal courts of appeal.¹²

This author will analyze inconsistent lower federal court opinions regarding the antitrust exemption under the McCarran-Ferguson Act.¹³ A discussion of these lower court opinions in the wake of the current Supreme Court test will provide a foundation for suggesting alternative approaches for granting an antitrust exemption to the insurance industry. Initial consideration will be given to the legislative intent behind the McCarran-Ferguson Act.¹⁴ In addition, this author will illustrate the analysis recently adopted by the Supreme Court to resolve the issue of whether activity of an insurance company constitutes the business of insurance.¹⁵

The problems lower courts are facing in light of the modern three-pronged test then will be explored.¹⁶ Despite a narrowed interpretation of the business of insurance, the McCarran-Ferguson exemption is being applied inconsistently. Inconsistent application of the exemption suggests the existence of confusion in the understanding of lower court decisions. Without a clear understanding of the scope of the exemption, lower courts are unable to advance the objective of all antitrust laws, namely, the protection of consumer welfare through unrestrained competition.

Finally, this author will propose alternatives to the current approach taken by the Supreme Court.¹⁷ The first alternative is an expansion of the current three-pronged test.¹⁸ The addition of a fourth prong that focuses the attention of courts on the welfare of the consumer would ensure that the interests of consumers are being considered. The second alternative to the current approach taken by the Court is the legislative adoption of a list of exempted insurance activities.¹⁹ A list has the advantage of providing predictable results for insurance companies that raise the McCarran-Ferguson Act as a defense to anti-

12. See *infra* notes 114-59 and accompanying text.

13. See *infra* notes 114-59 and accompanying text. A discussion of the entire McCarran-Ferguson Act is beyond the scope of this comment. Discussion in this comment is limited to interpretation of the term, "business of insurance," as contemplated within the meaning of the McCarran-Ferguson Act.

14. See *infra* notes 48-59 and accompanying text.

15. See *infra* notes 104-13 and accompanying text.

16. See *infra* notes 114-59 and accompanying text.

17. See *infra* notes 174-90 and accompanying text.

18. See *infra* notes 177-83 and accompanying text.

19. See *infra* notes 184-87 and accompanying text.

trust litigation. A final alternative is to abandon completely the anti-trust exemption for the insurance industry.²⁰ Economic pressures that spawned the adoption of the antitrust exemption may no longer exist. Recent studies suggest that rather than a limited antitrust exemption for insurance companies, unrestrained competition would be better suited to modern economic conditions.²¹ Promotion of unrestrained competition is the purpose of the Sherman Act.²² Therefore, a discussion of the Sherman Act and the Supreme Court opinions that brought activities of insurance companies within the regulatory power of Congress will be the starting point for exploring the antitrust exemption for the business of insurance.

THE SHERMAN ACT

The first federal antitrust statute, known as the Sherman Act, was adopted in 1890.²³ The statute represented the culmination of decades of effort to preclude the formation of monopolies and prevent abuses of economic power that consumers had suffered at the hands of the railroads, the Standard Oil Trust, and other economic giants.²⁴ The statute declared illegal any agreement in restraint of trade or interstate commerce.²⁵ Activity subject to the statute had to be within the power of Congress to regulate. Prior to 1944, the Supreme Court consistently held that the insurance industry was not subject to federal regulation.²⁶ Since the industry was not subject to regulation, the federal antitrust laws did not apply.

The leading decision on the issue of whether activities of insurance companies were within the power of Congress to regulate was the 1868 case of *Paul v. Virginia*.²⁷ In *Paul*, the Supreme Court held that the commerce clause of the United States Constitution did not deprive the individual states of the power to regulate and tax specific activities of foreign insurance companies selling policies within the territories of the individual states.²⁸ The Court noted that an insurance

20. See *infra* notes 188-90 and accompanying text.

21. See *infra* notes 163-70 and accompanying text.

22. See 90 Cong. Rec. A4405 (1944).

23. 15 U.S.C. §§1-7.

24. See A. Thompson, *Antitrust And The Health Care Provider* 3 (1979).

25. 15 U.S.C. §1. Courts have emphasized that only unreasonable restraints are prohibited. See *Northern Pac. Ry. v. United States*, 356 U.S. 1, 5 (1958).

26. See *United States v. South-Eastern Underwriters Association*, 322 U.S. 533, 543-44 (1943).

27. 75 U.S. 168 (1868).

28. *Id.* at 183.

contract was a wholly intrastate transaction.²⁹ The insurance industry, therefore, did not affect interstate commerce³⁰ and was not subject to the Sherman Act.

After seventy-five years, the Supreme Court departed from the *Paul* rationale in the case of *United States v. South-Eastern Underwriters Association*.³¹ The Court noted that the insurance industry greatly impacted upon the trade and commerce of our Nation.³² Activities conducted across state lines, therefore, were not beyond the regulatory power of Congress under the commerce clause.³³ The Court also noted that the interference with free competition with which the underwriters were charged was exactly the conduct that the Sherman Act outlawed.³⁴ The Court, therefore, held that the business of insurance affected interstate commerce and could be subjected to federal regulation, including antitrust laws.³⁵

The majority opinion sparked widespread criticism.³⁶ Some states feared that they no longer could tax or regulate the insurance industry.³⁷ Representatives of the insurance industry believed that the states were in a better position to regulate the industry.³⁸ The dissenters in *South-Eastern Underwriters* did not object to the recognition of congressional power to regulate the insurance industry; rather they objected to the consequent loss of state authority to regulate the industry.³⁹ Congress responded quickly to the case and the criticism. Within two years, the McCarran-Ferguson Act was adopted.

THE MCCARRAN-FERGUSON ACT

Congress responded to the decision of the Supreme Court in *South-Eastern Underwriters* by passing the McCarran-Ferguson Act in 1945.⁴⁰ In pertinent part, the Act provides that "the business of

29. *Id.*

30. *See id.*

31. 322 U.S. 533 (1943).

32. *Id.* at 539. "Perhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business." *Id.* at 540.

33. *Id.* at 553.

34. *Id.* at 536.

35. *Id.* at 553.

36. Anderson, Insurance And Antitrust Law: The McCarran-Ferguson Act And Beyond, 25 WM. & MARY L. REV. 81, 85 (1983).

37. *Id.*

38. *Id.*

39. *South-Eastern*, 322 U.S. 533, 562-63 (Stone, C. J., dissenting). *Id.* at 585 (Jackson, J., dissenting in part).

40. Anderson, *supra* note 36, at 85-87.

insurance . . . shall be subject to the laws of the several States which relate to the regulation or taxation of such business."⁴¹ The Act expressly preserves state authority to tax and regulate the insurance industry.⁴² In addition, the Act protects state authority by providing a limited exemption from federal antitrust law for the business of insurance, but only to the extent that the activity is regulated by state law.⁴³

The primary purpose of the McCarran-Ferguson Act is to preserve state regulation of insurance companies, as regulation of those activities existed prior to the decision in *South-Eastern Underwriters*.⁴⁴ A secondary purpose of the Act is to grant an exemption from federal antitrust laws to activities determined to constitute the business of insurance.⁴⁵ Congress, however, did not intend to revive the blanket exclusion from federal antitrust laws that the insurance industry enjoyed prior to the *South-Eastern Underwriters* case.⁴⁶ In addition, interpretation of the Act supports the proposition that the business of insurance is exempt from federal antitrust laws only if the activity is the type envisioned by Congress.⁴⁷ A short review of the McCarran-Ferguson legislation will provide some understanding of the intent of Congress in exempting the business of insurance.

LEGISLATIVE INTENT OF THE EXEMPTION FROM ANTITRUST LAWS FOR THE BUSINESS OF INSURANCE

Immediately following the district court decision in *South-Eastern Underwriters*, legislation was introduced in Congress that would have exempted completely the insurance industry from the federal antitrust laws.⁴⁸ The proposed legislation provided that nothing in the federal antitrust laws would be applied to the business of insurance.⁴⁹ The proposed legislation received limited support and eventually failed.⁵⁰

41. 15 U.S.C. §1012. The Act provides that the business of insurance is exempt from federal regulation only to the extent that the activity is regulated by state law. *Id.* §1013.

42. *Id.*

43. *Id.*

44. *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 218 n.18 (1978).

45. *Id.*

46. *Id.* at 220. Unsuccessful attempts by members of Congress to enact a blanket exemption illustrate this point. *Id.*

47. See 15 U.S.C. §1013(b).

48. 90 Cong. Rec. 6565 (1944); see *Royal Drug*, 440 U.S. at 219.

49. *Royal Drug*, 440 U.S. at 219 n.19.

50. *Id.* at 219. The bills favoring total exemption failed because of an anticipated veto by President Roosevelt. See 91 Cong. Rec. 1087 (1945) (remarks of Rep. Hancock). Moreover,

Prior to the passage of the McCarran-Ferguson Act, the National Association of Insurance Commissioners (NAIC) presented a report to the United States Senate.⁵¹ The report concluded that the unrestricted competition contemplated by the antitrust laws should not be applied to the insurance industry.⁵² The insurance commissioners were interested more in preserving state regulation of the industry than in excluding the industry from federal antitrust scrutiny.⁵³ The recommendation of the NAIC to the Senate concerned the promotion of intra-industry cooperative activities and not cooperative activities that an insurance company might engage in with others outside the insurance industry.⁵⁴ The recommendation was intended to place outside the scope of the Sherman Act those activities regarded by Congress to be in the public interest despite a technical violation of the antitrust laws.⁵⁵ Seven specific practices to which the Sherman Act should not apply were enumerated in the recommendation.⁵⁶ The McCarran-Ferguson Act, however, was enacted without the specific list recommended by the NAIC.

The legislation eventually enacted was introduced by Senators McCarran and Ferguson. The bill represented a compromise between those who favored full and immediate application of the antitrust laws to the insurance industry and those who favored an absolute exemption.⁵⁷ The exemption for the business of insurance was not intended to protect overly predatory conduct by insurers who wished

only a small segment of the insurance industry supported the legislation. See Weller, *The McCarran-Ferguson Act's Antitrust Exemption For Insurance: Language, History and Policy*, 1978 DUKE L.J. 587, 592 n.34.

51. 90 Cong. Rec. A4403-08 (1944). *Royal Drug*, 440 U.S. at 221.

52. 90 Cong. Rec. A4405 (1944). The Commissioners stated that combined efforts for statistical and rate-making purposes were necessary for smaller enterprises and insurers who were unable to underwrite risks accurately. *Id.* The inability to underwrite risks accurately would lead to eventual insolvency. *Id.*

53. See Weller, *supra* note 50, at 593.

54. See *Royal Drug*, 440 U.S. at 222.

55. 90 Cong. Rec. A4407 (1944).

56. The proposal provided that the Sherman Act should not apply to: (1) any agreement or concerted or cooperative action which prescribed the use of rates; (2) the use of those rates; (3) any cooperative or joint service, adjustment, investigation, or inspection agreement relating to insurance; (4) any agreement or concerted or cooperative action among two or more insurers to insure, reinsure, or otherwise apportion the risks; (5) any agreement or concerted action with respect to the payment of insurance agents or brokers; (6) any agreement or concerted action with respect to the collection and use of statistics; and (7) any agreement or concerted action providing for the cooperative making of insurance rates, rules, or plans. 90 Cong. Rec. A4405 (1944). Although the proposed legislation was not enacted, the proposal is important because the McCarran-Ferguson Act was based in large part upon the NAIC proposal. *Royal Drug*, 440 U.S. at 221. An amended version of the McCarran-Ferguson bill deleted the list of specific activities. Weller, *supra* note 50, at 596.

57. Anderson, *supra* note 36 at 86.

to extinguish competition, but was intended to enable insurers to underwrite risks accurately through cooperative ratemaking practices.⁵⁸ In that way, the insurer would remain reliable and solvent for the benefit of the insured.⁵⁹

Unfortunately, Congress failed to provide a definition of the term business of insurance. Thus, the stage was set for judicial interpretation. A review of significant Supreme Court decisions will illustrate the problems the Court has faced due to judicial inability to define adequately what constitutes the business of insurance.

DEFINING BUSINESS OF INSURANCE

In *SEC v. National Securities, Inc.*,⁶⁰ the Supreme Court attempted to define the business of insurance. The Court stated that Congress was concerned with state regulation that focused on the insurance contract.⁶¹ Although the exact scope of the statutory term was unclear, the Court believed that the focus should be on the relationship between the insurance company and the policyholder.⁶² Statutes regulating that relationship, directly or indirectly, were laws regulating the business of insurance.⁶³

Despite this seemingly workable standard, the exemption for the business of insurance recently has come under increased scrutiny by the Supreme Court.⁶⁴ This renewed interest largely is in response to new approaches taken by insurers, particularly in the healthcare field, to control rising claim costs.⁶⁵ New approaches, such as third party provider agreements, frequently reduce competition among insurers

58. 15 U.S.C. §1013(b). The exemption does not extend to predatory conduct arising from boycott, coercion, or intimidation. *Id.*, see Kallstrom, *Health Care Cost Control By Third Party Payors*, 1978 DUKE L.J. 645, 684.

59. See 91 Cong. Rec. 1481 (1945). "[W]e cannot have open competition in fixing rates on insurance. If we do, we shall have chaos. There will be failures, and failures always follow losses." *Id.* (remarks of Senator Ferguson).

60. 393 U.S. 453 (1969).

61. *Id.* at 460.

62. *Id.*

63. *Id.*

64. See *infra* notes 69-113 and accompanying text.

65. Anderson, *supra* note 36, at 82 n.3. Examples of these new approaches are "third party provider agreements" and "peer review committees." *Id.* A third party provider agreement is an agreement between an insurance company and a provider of a good or a service. *Id.* Although not a party to an insurance contract, the third party provider agrees to provide a good or service to a policyholder of the insurance company. *Id.* Peer review committees commonly are found in the chiropractic field. *Id.* The committee is hired to examine a chiropractor's statements, the fees charged, and to render an opinion regarding the necessity for the treatments. *Id.* at 110.

and, consequently, have been challenged under the federal antitrust laws.⁶⁶ In *Group Life & Health Co. v. Royal Drug Co.*,⁶⁷ the Supreme Court responded by formulating a test for determining whether an activity was exempt from federal antitrust law.⁶⁸

ROYAL DRUG AND THIRD PARTY PROVIDERS

Group Life & Health Insurance Co. v. Royal Drug Co. involved an insurance company that offered policies entitling the insured to obtain prescription drugs.⁶⁹ The insured was allowed to obtain the drugs from a pharmacy participating in the pharmacy agreement with the insurance company.⁷⁰ The agreement provided that if the policyholder purchased the drugs from a participating pharmacy, the policyholder paid only two dollars for every prescription drug, with the remainder of the cost paid directly by the insurance company.⁷¹ The insured also had the option of purchasing the drugs from a non-participating pharmacy.⁷² If the insured purchased drugs from a non-participating pharmacy, however, the insured paid full price and was entitled to *partial* reimbursement from the insurance company.⁷³

The insurance company in *Royal Drug* offered to enter into a third party provider agreement with each licensed pharmacy in Texas.⁷⁴ The participating pharmacy agreed to furnish policyholders prescription drugs at two dollars each, with the insurance company agreeing to reimburse the pharmacy for the cost of acquiring the drug.⁷⁵ The Supreme Court noted that only pharmacies able to afford to distribute the prescription drugs for less than the two dollar mark up could participate profitably in the plan.⁷⁶ Non-participating pharmacies brought an antitrust action alleging that Group Life & Health Insurance

66. *Id.* at 109.

67. 440 U.S. 205 (1978).

68. See *infra* notes 69-113 and accompanying text.

69. *Royal Drug*, 440 U.S. at 209.

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.* "Suppose the usual and customary retail price for a quantity of Drug X charged both by 'participating' Pharmacy A and 'non-participating' Pharmacy B is \$10, and the wholesale price (or acquisition cost) to both is \$8. If an insured buys Drug X from Pharmacy A, the insured pays \$2. Pharmacy A receives \$2 from the insured and \$8 from Blue Shield, or \$10. If an insured buys Drug X from Pharmacy B, the insured pays Pharmacy B \$10, and receives \$6 (75% of the difference between the retail price and \$2) from Blue Shield. While Pharmacy B receives the same as Pharmacy A, the insured must pay \$4 for the drug and must take steps to obtain reimbursement." *Id.* at 209 n.3 (quoting amicus curiae brief of the United States).

74. *Id.*

75. *Id.*

76. *Id.*

Company and three participating pharmacies had violated Section 1 of the Sherman Act by entering into agreements fixing the retail prices of drugs.⁷⁷

The trial court granted summary judgment for the defendants on the ground that the challenged agreements were exempt from the federal antitrust laws under the McCarran-Ferguson Act.⁷⁸ The Supreme Court, however, granted certiorari because of conflict among the various circuit courts of appeals as to the scope of the McCarran-Ferguson antitrust exemption.⁷⁹ Holding that third party provider agreements did not constitute the business of insurance, the Court found two factors to be important. The first factor related to spreading the risk incurred by the insurance company, and the second factor related to examination of the contract between the insurer and the insured.

A. *Spreading The Risk*

The first factor the Court in *Royal Drug* found important was whether the activity involved a spreading of the risk that the insurance company assumed in return for the payment of the premium by the policyholder.⁸⁰ The Court distinguished the spreading of risk from the reduction of risk.⁸¹ According to the majority, only the former was exempted as the business of insurance under the Act.⁸² Spreading of the risk was held to be the primary characteristic of an insurance contract.⁸³ The Court stated that the agreements between the insurance company and the participating pharmacies only served to minimize the costs that the insurance company incurred in fulfilling underwriting obligations.⁸⁴

77. *Id.* at 207.

78. *Id.*

79. *Id.* at 208.

80. *Id.* at 211.

81. *Id.* at 211-15. Quoting from a House Report, the Court noted: "The theory of insurance is the distribution of risk according to hazard, experience, and the law of averages. These factors are not within the control of insuring companies in the sense that the producer or manufacturer may control cost factors." H.R. Rep. No. 873, 78th Cong., 1st Sess., 8-9 (1943). See also S. Rep. No. 1112, 78th Cong., 2d Sess., 6 (1944); 90 Cong. Rec. 6526 (1944) (remarks of Rep. Hancock); *Royal Drug*, 440 U.S. at 221. The Court also noted the congressional recognition that insurance companies were not able to control costs as further evidence that pharmacy agreements, solely designed to minimize costs, were not the business of insurance. See *Royal Drug*, 440 U.S. at 221 n.25.

82. *Royal Drug*, 440 U.S. at 212-15.

83. *Id.*

84. *Id.* at 213. The Court noted that the pharmacy agreement between Blue Shield and

The Supreme Court also recognized that some provider agreements were necessary for the existence of some health care plans.⁸⁵ That a provider agreement is necessary, however, does not guarantee that a provider agreement constitutes the business of insurance.⁸⁶ The Court noted that the agreements may constitute sound business practices and may benefit the policyholders in the form of lower premiums, but this did not mean the agreements constituted the business of insurance.⁸⁷ Agreements between the insurer and a third party that are designed solely to minimize costs do not involve risk spreading and, therefore, are not the business of insurance.⁸⁸ Reduction of the amount of money an insurance company must pay a policyholder reduces the liability of the company and, therefore, the risk.⁸⁹ To qualify as the business of insurance, however, the activity must spread the risk of loss that the insurance company agreed to underwrite.⁹⁰ In addition, the Supreme Court found that the risk spreading activity must relate to the contract between the insurance company and the policyholder.⁹¹

B. *Contracts With Third Parties*

The second factor the *Royal Drug* court found important was whether the activity of the insurance company related to the contract between the company and the policyholder.⁹² Initially, the Court noted that pharmacy agreements were separate contractual arrangements between the insurance company and the pharmacies.⁹³ Pharmacies were engaged in the sale and distribution of goods and services other than insurance.⁹⁴ To constitute the business of insurance, the Court held

the pharmacy effectively reduced the total amount that Blue Shield was obligated to pay to policyholders. *Id.* at 214. The agreements enabled Blue Shield to minimize costs and maximize profits. *Id.* The cost arrangements might be sound business practices and ultimately might benefit the insured, although there is no guarantee that the cost saving would be passed on to the policy holder. *Id.* Still, those agreements are not the business of insurance. *Id.*

85. *Id.* at 213 n.9.

86. *Id.*

87. *Id.* at 214.

88. *Id.* at 221.

89. *Id.* at 214 n.12.

90. *See id.* at 211. "It is characteristic of insurance that a number of risks are accepted, some of which involve losses, and that such losses are spread over all the risks so as to enable the insurer to accept each risk at a slight fraction of the possible liability." 1 G. Couch, *CYCLOPEDIA OF INSURANCE LAW* §1.2(a) (1971).

91. *See infra* notes 92-99 and accompanying text.

92. *Royal Drug*, 440 U.S. at 215.

93. *Id.* at 216.

94. *Id.*

that the activity exempted under the McCarran-Ferguson Act must be between the insurer and insured.⁹⁵

The insurance company argued that the pharmacy agreements so closely affected the reliability, interpretation and enforcement of the insurance contract, and so closely related to status as reliable insurers, that the pharmacy agreements fell within the exemption.⁹⁶ The Court, however, rejected the broad interpretation urged by the petitioners.⁹⁷ The Court stated acceptance of that interpretation would permit every business decision of an insurance company an exemption from federal antitrust scrutiny.⁹⁸ Consequently, the Supreme Court held that provider agreements could not be considered part of the business of insurance.⁹⁹

Finally, the Court noted that the narrow construction of antitrust law exemptions was a well settled principle.¹⁰⁰ The Supreme Court reiterated that the primary concern of Congress underlying the anti-trust exemption of the McCarran-Ferguson Act was that cooperative ratemaking efforts of insurance companies be exempted from antitrust laws.¹⁰¹ As the provider agreements involved parties wholly outside the insurance industry who were not involved in ratemaking activities, the provider agreements did not constitute activities that fell within the meaning of the business of insurance.¹⁰²

The Supreme Court in *Royal Drug* provided an innovative analysis for lower courts. Within four years, however, the issue whether activity of an insurance company constituted the business of insurance returned to the Supreme Court.¹⁰³ This time the Court clearly identified a three-pronged test for determining what activity constituted the business of insurance.

PIRENO AND PEER REVIEW COMMITTEES

In *Union Labor Life Ins. Co. v. Pireno*,¹⁰⁴ the Supreme Court held that the use of a professional association peer review committee¹⁰⁵

95. *Id.* at 215.

96. *Id.* at 216.

97. *Id.* at 217.

98. *Id.*

99. *Id.* at 232-33.

100. *Id.* at 231.

101. *Id.* at 221.

102. *Id.* at 231.

103. See *infra* notes 104-13 and accompanying text.

104. 102 S. Ct. 3002 (1982).

105. See *supra* note 65.

by a health insurer did not constitute the business of insurance.¹⁰⁶ The peer review committee was hired to examine a chiropractor's statements, the fees charged, and to render an opinion as to the necessity of the treatments.¹⁰⁷ Citing *Royal Drug*, the Court identified three relevant criteria to determine whether a particular practice qualified as the business of insurance. The first criterion was whether the activity played a part in spreading the risk of the insurance company.¹⁰⁸ The second criterion was whether the activity was between the insurance company and the policyholder rather than the insurance company and a third party.¹⁰⁹ The third criterion was whether the activity was limited to parties within the insurance industry.¹¹⁰ The Supreme Court stated that none of these criterion necessarily was determinative and all would be applied on a case by case basis.¹¹¹ Examining the arrangement with respect to all the criteria, however, the Court concluded that the arrangement was not part of the business of insurance.¹¹² Formulation of the three-pronged test in both *Pireno* and in *Royal Drug*, to a great extent, was based upon the legislative history of the exemption.¹¹³ Despite Supreme Court clarification regarding the scope of the McCarran-Ferguson antitrust exemption, lower federal courts continue to struggle to understand and implement the latest interpretation.

A CONTINUING STRUGGLE IN LOWER COURTS

In *Proctor v. State Farm Mut. Auto Ins. Co.*,¹¹⁴ the United States Court of Appeals for the District of Columbia was presented with the problem of applying the McCarran-Ferguson exemption in light of the Supreme Court opinion in *Royal Drug*. *Proctor* involved a suit against five automobile insurance companies brought by several automobile repair shops.¹¹⁵ The plaintiffs alleged that the insurance companies had conspired to fix prices of automobile body damage repair work in violation of the Sherman Antitrust Act.¹¹⁶

The Court of Appeals conceded the current uncertainty of the

106. *Pireno*, 102 S. Ct. at 3009.

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. *See id.* at 3007-11.

114. 675 F.2d 308 (D.C. Cir. 1982).

115. *Id.* at 310-12.

116. *Id.*

business of insurance exemption under the McCarran-Ferguson Act.¹¹⁷ Nevertheless, the court held that the activity of the insurance companies, artificially depressing the price of auto repair, constituted the business of insurance.¹¹⁸ The court relied upon other circuit court of appeal opinions to formulate a rationale.¹¹⁹ After illustrating that circuit courts differed widely in approach to defining the business of insurance, the *Proctor* court found that the agreements were wholly intra-industry, were similar to cooperative ratemaking, and, therefore, the exemption was applicable.¹²⁰

The problem with the *Proctor* decision is not that the three-pronged test was misapplied. The problem lies in the fact that the *Proctor* court was unable to apply the three-pronged test with any certainty.¹²¹ The court in *Proctor* found the test difficult to interpret and difficult to apply.¹²²

The Ninth Circuit Court of Appeals also has experienced problems applying the three-pronged test of the Supreme Court. In one case, the circuit court advocated a narrow interpretation of all antitrust exceptions.¹²³ In another case, however, the same court went to great lengths to justify the exemption of a third party provider agreement.¹²⁴ The Supreme Court intended to provide a means to harmonize the opinions of the various lower courts rather than perpetuate the uncertainty.¹²⁵

The Ninth Circuit Court of Appeals has acknowledged that the exemption from federal antitrust laws for the business of insurance should be construed narrowly.¹²⁶ *United States v. Title Ins. Rating Bureau of Arizona*,¹²⁷ involved an alleged illegal combination among the defendants.¹²⁸ The plaintiffs alleged that the defendants had fixed the prices of escrow services in violation of the Sherman Act.¹²⁹ Based upon a factual analysis involving risk spreading, the court reasoned

117. *Id.* at 318-19.

118. *Id.*

119. *Id.* at 319-21.

120. *Id.* at 320-21. The court noted that this reasoning was in line with the rationale of *Royal Drug*, which was based on legislative intent. *Id.* at 321.

121. *Id.* at 321.

122. *Id.* at 312.

123. See *infra* notes 127-39 and accompanying text.

124. See *infra* notes 135-51 and accompanying text.

125. *Royal Drug*, 440 U.S. at 208.

126. *United States v. Title Ins. Rating Bureau of Ariz.*, 700 F.2d 1247, 1249 (9th Cir. 1983).

127. 700 F.2d 1247 (9th Cir. 1983).

128. *Id.* at 1249.

129. *Id.*

that the escrow arrangement properly was characterized as a cost reducer rather than a risk spreader.¹³⁰ The court implied, however, that satisfaction of the other two prongs was unclear.¹³¹ The court of appeals never stated whether the agreement between the defendants and the escrow service was related to the agreement between the insurer and the insured.¹³² In addition, the court never stated whether the challenged activity was limited to entities within the insurance industry.¹³³ Nevertheless, the court held that the agreements did not constitute the business of insurance for purposes of the McCarran-Ferguson Act and therefore were subject to federal antitrust scrutiny.¹³⁴

In a case decided at virtually the same time as *Rating Bureau*, however, the Ninth Circuit held that provider agreements between a health insurer and participating pharmacies were exempt from federal antitrust scrutiny based on the McCarran-Ferguson Act.¹³⁵ The case of *Klamath-Lake Pharmaceutical v. Klamath Medical Service Bureau*¹³⁶ involved an antitrust action brought against a healthcare provider that offered prescription drug benefits available only at the pharmacy of the third party provider.¹³⁷ The facts of the case were almost identical to those in *Royal Drug*.¹³⁸ The only relevant distinction between these cases is that in *Klamath-Lake*, the health insurer purchased the pharmacies some time after the health insurer began the drug benefit program in agreement with the participating pharmacies.¹³⁹ The policyholders, then, were required to have their prescriptions filled by the health insurer.¹⁴⁰

The Ninth Circuit determined that the provider agreements were exempt from antitrust scrutiny.¹⁴¹ The court reasoned that the agreements between the insurer and the policyholder clearly were exempt from federal antitrust scrutiny so, *a fortiori*, the provider agreements were exempt.¹⁴² The conclusion that agreements between the insurance company and the policyholder were exempt under the

130. *Id.* at 1251.

131. *See infra* notes 132-33 and accompanying text.

132. *See id.* at 1252.

133. *Id.* at 1251-52.

134. *Id.* at 1252.

135. *See infra* notes 136-51 and accompanying text.

136. 701 F.2d 1276 (9th Cir. 1983).

137. *Id.* at 1279-80.

138. *Compare id.* with *supra* notes 69-77 and accompanying text to note the factual similarity.

139. *Klamath*, 701 F.2d at 1280.

140. *Id.*

141. *Id.* at 1286.

142. *Id.*

McCarran-Ferguson Act was correct. In light of the rationale in *Royal Drug*, however, the conclusion that the provider agreements also were exempt was incorrect.

The Ninth Circuit Court noted that the Supreme Court in *Royal Drug* did not exclude all health insurance contracts from the business of insurance despite the fact that some of these contracts did not constitute the type of insurance contemplated by the McCarran-Ferguson Act.¹⁴³ The Ninth Circuit, however, was under the impression that the exemption shielding the health insurer from antitrust scrutiny also shielded the third party provider agreements.¹⁴⁴ In light of the factual similarity between *Royal Drug* and *Klamath-Lake*, however, the results in these two cases should have been the same.

Despite facts distinguishing *Klamath-Lake* from *Royal Drug*, the Ninth Circuit Court cannot justify exempting the provider agreements. In *Royal Drug*, the Supreme Court addressed a factual situation similar to *Klamath-Lake*. The Court remarked that even though an insurance company acquires a chain of drug stores in an effort to lower the cost of meeting underwriting obligations, the acquisition is unrelated to the contract between the insurer and the insured.¹⁴⁵ Any relationship between the insurer and the insured is established when the contract is formed.¹⁴⁶ Therefore, any acquisition by the insurance company after the formation of the insurance policy is not exempt from federal antitrust scrutiny.

In *Klamath-Lake*, the insurer acquired the drug stores in an effort to lower costs of meeting underwriting obligations.¹⁴⁷ The acquisition was a perfect example of risk reduction that the Supreme Court characterized as outside the scope of the McCarran-Ferguson antitrust exemption. The purpose of the exemption was not to provide an insurer with the power to reduce competition. Thus, the acquisition of the pharmacies should not have been characterized as the business of insurance.

In addition, the Supreme Court has warned of the possible anti-competitive consequences resulting from provider agreements.¹⁴⁸ In *Royal Drug*, the Court noted that the existence of third party provider agreements has resulted in rapid escalation of health care costs

143. See *id.*; *Royal Drug*, 440 U.S. at 230 n.37.

144. *Klamath*, 701 F.2d at 1286.

145. *Royal Drug*, 440 U.S. at 215.

146. See *Royal Drug*, 440 U.S. at 216.

147. See *Klamath*, 701 F.2d at 1280.

148. See *infra* note 149 and accompanying text.

to the detriment of the consumer.¹⁴⁹ The Ninth Circuit noted the anti-competitive impact of provider agreements but declined to take that factor into account.¹⁵⁰ From the foregoing cases,¹⁵¹ the uncertainty and inconsistency with which lower courts have approached the problem of deciding what the business of insurance actually is becomes apparent.

Intercircuit conflict brought the issue before the Supreme Court in *Royal Drug*.¹⁵² After *Royal Drug*, but prior to *Pireno*, the Court of Appeals for the District of Columbia attempted to apply the three-pronged test of *Royal Drug*.¹⁵³ The decisions of the Ninth Circuit have been inconsistent with those of the Supreme Court.¹⁵⁴ The Ninth Circuit adopted a narrow view of antitrust exemptions in one case,¹⁵⁵ yet went to great lengths in another case to extend the McCarran-Ferguson antitrust exemption beyond the limits prescribed by the Supreme Court.¹⁵⁶ Due to the continuing uncertainty of what activity constitutes the business of insurance, the issue likely will be brought before the United States Supreme Court again.

A close reading of both *Royal Drug* and *Pireno* suggests that the broad standards previously established by courts for interpreting the business of insurance exemption are no longer acceptable.¹⁵⁷ The proper standards to be applied, however, are unclear. Lower federal courts have failed to apply the Supreme Court test consistently.¹⁵⁸ This failure indicates that the three-pronged test does not supply lower courts with sufficient guidance. In addition, the value of the antitrust exemption recently has been questioned.¹⁵⁹

149. See *Royal Drug*, 440 U.S. at 232 n.40. "Recent studies have concluded that physicians and other health care providers typically dominate the boards of directors of Blue Shield plans. Thus, there is little incentive on the part of the Blue Shield to minimize costs, since it is in the interest of the providers to set fee schedules at the highest possible level. This domination of Blue Shield by providers is said to have resulted in rapid escalation of health care costs to the detriment of consumers generally." *Id.*

150. See *Klamath*, 701 F.2d at 1280.

151. See *supra* notes 114-47 and accompanying text.

152. *Royal Drug*, 440 U.S. at 208, n.2.

153. See *supra* notes 114-22 and accompanying text.

154. Compare *supra* notes 114-47 and accompanying text with *supra* notes 69-113 and accompanying text to note the inconsistency.

155. See *supra* notes 126-34 and accompanying text.

156. Compare *Rating Bureau*, 700 F.2d 1247 with *Klamath-Lake*, 701 F.2d 1276.

157. Kennedy, *The McCarran Act: A Limited "Business Of Insurance" Antitrust Exemption Made Ever Narrower-Three Recent Decisions*, 18 *FORUM* 528, 538 (1982). Kennedy suggests that the vitality of the business of insurance exemption is substantially stifled by uncertainty in the industry. *Id.* He also suggests that continued viability of the exemption as a defensive shield from vexatious litigation has been cast in doubt. *Id.*

158. See *supra* notes 114-47 and accompanying text.

159. See *infra* notes 160-73 and accompanying text.

QUESTIONING THE NECESSITY OF THE EXEMPTION

The insurance industry has undergone significant change since the enactment of the McCarran-Ferguson Act in 1945.¹⁶⁰ The industry no longer is dominated by tight cartels¹⁶¹ or uniform regulatory supervision of collective ratemaking activities.¹⁶² The justification for anti-trust immunity, therefore, must be evaluated in light of present conditions.

In January 1977, the U.S. Department of Justice released a report that analyzed the effects of the antitrust exemption on the insurance industry.¹⁶³ The report stated that full price competition,¹⁶⁴ rather than cooperative ratemaking,¹⁶⁵ could provide an effective means of achieving reasonable prices and maximum efficiency in the sale and distribution of insurance.¹⁶⁶ The report concluded both that the insurance industry should be able to conduct business without any special exemption from federal antitrust laws and that an alternative scheme of regulation without the McCarran-Ferguson exemption might be desirable.¹⁶⁷

In 1979, the National Commission for the Review of Antitrust Laws and Procedures released a report that considered the effectiveness of the McCarran-Ferguson Act.¹⁶⁸ The report concluded that the broad antitrust immunity embodied in the McCarran-Ferguson Act should be repealed.¹⁶⁹ The Commission recommended that narrowly drawn legislation be enacted to establish the lawfulness of a limited number of essential collective activities.¹⁷⁰

The recommendation of the Commission that a specific list of essential collective activities¹⁷¹ be exempt from the antitrust laws is in line

160. Kemp, *Insurance And Competition*, 17 *IDAHO L. REV.* 547, 548 (1981).

161. A cartel is a combination of producers joined together to control production of a product and to obtain a monopoly in any particular industry. *See BLACK'S LAW DICTIONARY* 195 (5th ed. 1979) (defining cartel).

162. *Id.*

163. U.S. Department of Justice, *Report Of The Task Group On Antitrust Immunities* (1979).

164. Full price competition is the effort of two or more parties, acting independently, to secure the business of a third party by the offer of the most favorable terms. *See BLACK'S LAW DICTIONARY* 257 (5th ed. 1979) (defining competition).

165. Cooperative ratemaking is the cooperative setting of premium rates by competing insurance companies. *See BLACK'S LAW DICTIONARY* 1070 (5th ed. 1979) (defining price-fixing).

166. U.S. Department of Justice, *Report Of The Task Group On Antitrust Immunities* 30 (1977).

167. *Id.* at 30-31. The basic question considered by the study was whether the present exemption of the business of insurance from antitrust laws has operated in the public interest. *Id.* at 29.

168. U.S. National Commission For The Review Of Antitrust Laws And Procedures (1979).

169. *Id.* at 225.

170. *Id.*

171. Cooperative ratemaking is an example of a collective activity. *See supra* note 165.

with the 1944 recommendation of the National Association of Insurance Commissioners.¹⁷² These recommendations have been based upon evaluations of fair competition, consumer welfare, and other fundamental policies behind the antitrust laws.¹⁷³ The recommended list, however, would be beneficial for a more basic reason. A list would provide insurance companies with an awareness of which anti-competitive activities are exempted from antitrust scrutiny.

These criticisms suggest that the antitrust exemption for the business of insurance is unsound. The problem of interpretation experienced by lower federal courts despite efforts by the Supreme Court to clarify the issue support this suggestion. Alternative approaches, therefore, must be considered.

ALTERNATIVES TO THE THREE-PRONGED TEST

The Supreme Court has identified three factors to consider when deciding whether a given activity constitutes the business of insurance.¹⁷⁴ The test, however, has not proved effective for lower courts.¹⁷⁵ The effectiveness has been impaired because lower courts struggle to interpret the three-pronged test established by the Supreme Court. The result is an uncertain application of an important antitrust exemption.¹⁷⁶

In light of the struggle the lower courts now face, alternatives to the three-pronged Supreme Court test must be explored. Consideration should be focused upon the interests of the consumer, the primary interests the antitrust laws are designed to protect. One possible alternative, a more restrictive interpretation of the current Supreme Court test, would ensure that the consumer is protected from anticompetitive forces. Another alternative is the enactment of a specific list of exempted activities. Specific exemptions based upon the best interests of the consumer would provide the courts, the insurance industry, and the public with a practical framework. A final alternative that must be considered is complete abandonment of the business of insurance exemption. A discussion of these three alternatives will be the focus of the remainder of this comment.

172. See *supra* note 56.

173. See 90 Cong. Rec. A4405 (1944).

174. See *supra* notes 108-10 and accompanying text.

175. See *supra* notes 114-59 and accompanying text.

176. *Id.*

A. Restricting the Three Prong Test

The three-pronged test developed in *Royal Drug* and *Pireno* was an attempt by the Supreme Court to provide lower courts with a solution to the problem of determining what constitutes the business of insurance for purposes of exemption from federal antitrust laws.¹⁷⁷ The first prong requires that the activity must spread the risk that the insurance company agrees to underwrite.¹⁷⁸ The second prong requires that the activity must be between the insurance company and the policyholder rather than between the insurance company and a third party.¹⁷⁹ Finally, the third prong requires that the activity must be limited to intra-industry activity.¹⁸⁰ Applying these three criteria, courts are expected to determine with consistency whether a given activity constitutes the business of insurance within the meaning of the McCarran-Ferguson Act. As previously illustrated,¹⁸¹ that goal has not been realized.

If courts were directed to consider an additional criterion, however, future decisions may not be so inconsistent. A fourth prong that would focus the reasoning of courts on the welfare of the consumer could be added to the existing Supreme Court test.¹⁸² Regardless of whether a given activity satisfies the first three prongs of the test, final consideration under the fourth prong should be whether exempting the activity is in the best interest of the public. Consideration of that factor would ensure that the primary purpose of the antitrust laws would be advanced. Still, none of these criterion necessarily are determinative and all should be applied on a case by case basis.

Addition of the public interest prong to the existing three-pronged test also would mean that courts would consider the interests of the public on a subjective level. Both parties to an action would be able to present evidence as to whether the public would benefit from exemption of the activity. If the court is not satisfied that exemption would be beneficial to the public, the activity would not be exempted. This alternative must be considered, however, in conjunction with any specific activities that Congress should decide to exempt statutorily.¹⁸³

177. See *Royal Drug*, 440 U.S. at 208.

178. *Pireno*, 102 S. Ct. at 3009.

179. *Id.*

180. *Id.*

181. See *supra* notes 114-59 and accompanying text.

182. An example of this fourth prong is: Notwithstanding satisfaction of the first three tests, if the given activity will not serve the best interests of the public, the activity is not exempt.

183. See *infra* notes 184-87 and accompanying text.

Consideration of all these factors would ensure that the public interest has been considered before anticompetitive forces legally may exist.

B. *Exempting Specific Activities*

Another alternative to the Supreme Court test is the compilation of a specific list of exempted activities. The difficulty in compiling such a list, however, would stem from the extensive debate among those concerned as to which activities should be exempt. The California Legislature recently faced a similar problem.

In 1984, the California Legislature attempted to enact AB 707.¹⁸⁴ AB 707 would have legalized the formation of combinations between health insurers and providers of medical care.¹⁸⁵ According to the language of AB 707, the purpose of the legislation was to ensure high quality health care in the most efficient and cost effective manner.¹⁸⁶ Opposition to the bill was fueled to a great extent by factions in the health care industry that wished to have their particular activity exempt and opposed exemption of any other activity.¹⁸⁷ In light of the possibility that the same concern may be raised at the federal level, Congress should be careful not to focus on the interests of an industry. Rather, Congress should focus on the interests of the consumer. Activity that would improve only the economic position of a business through anti-competition should not be exempt. Activity that would tend to lower costs to the consumer, however, is the type of activity that should be exempt. Consumer welfare must be the primary consideration.

The need for a list is great. The list would relieve courts of the burdensome application of the current three-pronged test. In addition, the insurance industry would be provided with predictable results if litigation results from the type of activity in which the insurance company engages. Most importantly, however, the consumer would be protected from undesirable anticompetitive forces in the marketplace. Since the protection of consumer welfare is the primary goal of the antitrust laws, a final alternative, that no exemption should exist, must be considered.

184. Assembly Bill 707, 1983-84 Regular Session (proposed addition to add §16770 to the Cal. Business and Professions Code; §1342.5 to the Cal. Health and Safety Code; §10133.6 to the Cal. Insurance Code).

185. *Id.*

186. *Id.*

187. See telephone conversation with Irene Ifhizaka, legislative assistant to Assemblyman Phillip Isenberg (January 22, 1985) (notes on file at Pacific Law Journal).

C. Repeal Of The Business Of Insurance Exemption

In 1977, the Department of Justice recommended a complete abandonment of the McCarran-Ferguson exemption for the business of insurance.¹⁸⁸ In 1979, the National Committee For The Review of Antitrust Laws concluded that the exemption from antitrust laws for the business of insurance should be repealed.¹⁸⁹ Also, the Supreme Court noted in *Royal Drug* that exemption of third party provider agreements resulted in rapid escalation of health care costs.¹⁹⁰ Congress cannot ignore the possibility, therefore, that the business of insurance exemption is outdated and may no longer be in the best interest of the public. Until Congress repeals the exemption, however, courts should have the opportunity to determine in a relatively easy fashion what the business of insurance is. Implementation by courts of a fourth prong ensuring consideration of the public welfare would provide courts with that opportunity until Congress can enact a specific list of exempted activities or repeal the exemption entirely.

CONCLUSION

The federal antitrust exemption for the business of insurance as provided in the McCarran-Ferguson Act has been the subject of much litigation and controversy during the past few decades. In early stages of judicial decision-making, the exemption was interpreted expansively by lower courts. As the case law developed in the Supreme Court, however, interpretation of the business of insurance narrowed. A three-pronged test was established by the Supreme Court to guide lower courts in resolving the issue of whether an activity of an insurer constituted the business of insurance as contemplated in the McCarran-Ferguson Act.

The three-pronged test, however, has proven less than adequate as a guide for lower courts. Evidence of this conclusion is found by examining the decisions of lower courts following the establishment of the three-pronged test. Lower courts are still struggling with the issue, and application of the Supreme Court test remains uncertain.

This author has pointed to the relevant policies behind the McCarran-Ferguson antitrust exemption for the business of insurance.

188. See *supra* notes 163-67 and accompanying text.

189. See *supra* notes 168-70 and accompanying text.

190. See *supra* notes 148-49 and accompanying text.

The business of insurance exemption, as applied by courts since the establishment of the three-pronged test, was analyzed. By illustrating the uncertainty that lower federal courts have experienced in applying the latest test, this author has shown the need for an alternative to the test devised by the Supreme Court.

Three alternatives to the Supreme Court test were suggested. The first alternative was the addition of a fourth prong to the existing three-pronged test. Under this fourth prong, when a court is deciding whether an activity constitutes the business of insurance, the court would consider whether exemption is in the public interest. This alternative has the advantage of providing the lower courts with a more definitive test than that which currently exists. In addition, this alternative advances the welfare of the consumer, the main policy supporting American antitrust law.

The second alternative proposed was the formulation of a specific list of exempted activities. Congress should focus primarily on activities that would benefit the consumer despite the anticompetitive character of the activity. This alternative has the advantage of providing courts with a specific list rather than a nebulous test.

Finally, evaluation of the business of insurance exemption is not complete until one considers the need for the exemption at all. Some authority suggests that the exemption is outdated and should be completely abandoned. This author believes, however, that complete abandonment is too severe. The insurance industry is not so stagnant that previously unconsidered activity might not be in need of exemption.

Until Congress does repeal the exemption, however, courts need a workable standard for deciding cases. In light of that need, Congress should adopt a specific list of exempted activities. Until a list is adopted, however, courts should apply a fourth prong to the existing Supreme Court test for determining what constitutes the business of insurance.

Eric Peter Gillett